# Credit Issues Surrounding Pension Liabilities & Pension Bonds



September 12, 2004



**Moody's Investors Service** 

#### **General Perspectives**

- The issuance of POBs, by itself, is not considered a credit negative and is generally not a cause for a rating downgrade.
- Issuance of POBs can be an effective tool for managing and reducing the cost of an Unfunded Pension Liability.
- A significant increase in an Unfunded Pension Liability can be a credit negative and a cause for a rating downgrade.

## Increase in Unfunded Pension Liability May Cause a Rating Change if it is Due to...

- significant increase in benefits with no long-term funding plan in place.
- unrealistic earnings or other assumptions.
- investment practices that are not conservative.
- annual contributions less than the actuarially determined amount.

### **Negatives of Issuing POBs**

- Replaces a "soft", fairly flexible obligation with "hard" debt.
- Arbitrage risk—system earnings may be less than cost of debt.
- Poor investment earnings or market crash after issuance of bonds, even if losses are recovered over time, may prove politically embarrassing.
- Fully-funded or over-funded system will be an incentive for increased benefits.

#### Ca Bas Basi Asa C Aa

#### **Factors Assessed in Rating POBs**

- Core Credit Factors—Economy, Debt Profile,
  Finances, and Management.
- Security Features of the POB—Specific Security,
  Pension Override Taxes Pledged, et. al.
- Judicial Validation.
- Structural Features of the POB—Level v.
  Escalating Debt Service, Term of Debt, Variable v.
  Fixed Rate Debt.
- Portion of Unfunded Liability Funded by POBs.
- Plan for Investing Proceeds.